



## STRENGTHENING THE GLOBAL TRADE AND INVESTMENT SYSTEM FOR SUSTAINABLE DEVELOPMENT



### **Disciplining Investment Incentives: A Lost Cause?**

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E15 Task Force on  
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**Think Piece**

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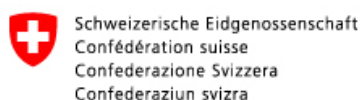
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# ABSTRACT

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Investment incentives rank among the most important policy instruments governments employ to influence the locational decisions of multinational firms. In the wake of the recent increase in locational competition and the growing impact of investment incentives and support measures for state-owned enterprises (SOEs), the need for enhanced disciplines on investment incentives has gained political and academic salience. This think piece explores the evolution of investment incentives from a development and rule-making perspective. It summarises the existing literature and examines current practices and recent trends in FDI flows and the use of various investment incentives. This is followed by a discussion of the reasons for the observed stalemate in attempts at disciplinary rule-making. The paper concludes by putting forth recommendations for data gathering and transparency that could further the move toward improved global governance founded on the increasing complementarities of trade, investment, and competition law and policy as the core pillars of a more open, inclusive, and just world economy.

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# CONTENTS

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Introduction	1
Defining Investment Incentives And Current Practices	1
Investment Incentives: Global And Regional Trends	2
Investment Incentives: A Development Perspective	3
The Political Economy Of Investment Incentive Rule-Making	5
Policy Recommendations	7
References	10

# LIST OF ABBREVIATIONS AND ACRONYMS

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BITs	Bilateral investment treaties
EU	European Union
FDI	Foreign direct investment
GATS	General Agreement on Trade in Services
GVC	Global value chain
IAs	International Investment Agreements
IPIs	Investment promotion institutions
IT	Information technology
ITO	International Trade Organization
MAI	Multilateral Agreement on Investment
MNEs	Multinational enterprises
OECD	Organisation for Economic Co-operation and Development
PTAs	Preferential trade agreements
R&D	Research and development
RTA	Regional trade agreement
SCM	Agreement on Subsidies and Countervailing Measures
SOE	State-owned enterprise
TRIMS	Agreement on Trade-Related Investment Measures
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
US	United States
VAT	Value added tax
WTO	World Trade Organization

# LIST BOXES

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Box 1. EU state aid rules and tax incentives

# INTRODUCTION

The rise of geographically dispersed production networks and value chains has greatly increased both the scope and intensity of locational competition over so-called efficiency-seeking foreign direct investment (FDI),<sup>1</sup> by far the most footloose of all types of FDI and most likely to respond to a proliferating set of investment incentives.

Investment incentives rank among the most important policy instruments governments employ to influence the locational decisions of multinational firms. An increasing (if somewhat contradictory) body of empirical evidence devoted to incentives recalls both their potency as tools of economic diversification and competitiveness alongside the potential they hold to distort the allocation of trade and investment that would prevail in their absence and thus their capacity to tilt competitive conditions in the markets in which they are at play.

While a number of mostly weak and indirect disciplines regulating the use of investment incentives can be found in various international instruments, host country governments have to date shown little political appetite for deepened rule-making in this area, revealing instead a recurring collective preference for preserving the policy space that may be needed to direct incentives at multinational investors and outbid competitors (at times within the same federal state) in fostering cross-border investment activity. Still, the political and academic debate on the possible need for new or enhanced disciplines on investment incentives retains — indeed has arguably gained — salience. It has done so in the light of an increase in locational competition fuelled by global value chains (GVCs) that puts some countries (typically poorer developing states) at a distinct disadvantage in the race for efficiency-seeking FDI, but also as a result of the growing impact exerted by home country incentives and support measures bestowed on state-owned enterprises (SOEs) as major new actors in outward FDI activity.

This think piece explores the evolution of investment incentives from a development and rule-making perspective. Section 2 provides a definition of investment incentives and details current practices, setting the context that frames the ensuing analysis. Section 3 reviews recent trends in FDI flows and what we know of the use of investment incentives. Section 4 summarises the existing literature and case studies on the effectiveness of investment incentives. This is followed in Section 5 by an overview of existing disciplines on investment incentives and a discussion of the reasons for the observed stalemate in attempts at disciplinary rule-making. Section 6 concludes by advancing a set of policy recommendations on disciplining investment incentives.

# DEFINING INVESTMENT INCENTIVES AND CURRENT PRACTICES

In competing to attract foreign investors, countries typically rely on two sets of policy instruments: investment promotion and investment incentives. The former generally refers to the activities carried out by investment promotion institutions (IPIs) to increase a country's visibility in the eyes of potential foreign investors and raise awareness about investment opportunities and prevailing regulatory and doing business conditions in the host state (Echandi, 2015, p. 6). With respect to the latter, although no universally agreed definition of investment incentives exists, the term most commonly refers to “non-market benefits that are conferred by a national, regional, or local governmental entity to economic actors with the purpose of influencing their investment decisions” (James, 2009). The Organisation for Economic Co-operation and Development (OECD) offers a variation on the above with the following hybrid definition of investment incentives: “measures designed to influence the size, location, or industry of an FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors” (OECD, 2003).

While investment incentives are primarily associated with attracting inward FDI, they can also target outward FDI activity. The latter is usually promoted through direct measures, such as financial, fiscal, information, and other support services, although governments do not disregard other indirect forms of support, such as trade-related (export credits), investment guarantees, or development assistance policies.

Incentives granted to attract inward FDI generally aim at improving the host country economy by means of knowledge

1 Efficiency-seeking investment occurs where investors seek to increase the cost efficiency of production by taking advantage of factors that improve firm-level competitiveness. These include, *inter alia*, lower labour costs or higher labour productivity, easier or even preferential access to export markets, access to key inputs and components, and more efficient international production and supply patterns. Efficiency-seeking investment is among the most difficult to attract and retain, not least because so many factors must align to make the host country an appropriate venue for a particular production process at a particular moment. Countries tend to compete aggressively for this type of investment. A key element in attracting such investment is the quality and cost competitiveness of a country's service infrastructure, from the “hardware” of physical infrastructure allowing goods and services to reach export markets efficiently and reliably to the “software” of skills and human capital required to upgrade to higher-value segments of supply chains.

and technology transfers, job creation, capital inflows, and access to markets. Outward FDI incentives tend to be more concerned with strengthening the competitive position of the parent (home country) company vis-à-vis international competitors from other countries in the host country (Sauvant et al., 2014).

Tax incentives, which are prevalent in many parts of the developing world and in transition economies, represent the most common type of incentive used to attract FDI. These chiefly take the form of foregone fiscal revenue. Indeed, the most frequent modalities of fiscal incentives impinge on income tax — exempted income, tax rebates, tax holidays and special corporate tax deductions; value added tax (VAT) — VAT zero rated goods, VAT exemption and remission; and customs duties — duty exemption and duty remission (Echandi, 2015). While less prevalent, countries with deeper pockets, both within and outside the OECD area, combine tax-related incentives with regulatory measures and financial incentives. These typically involve a direct transfer of funds to targeted enterprises, the provision of goods and services, the building of production infrastructures, as well as various payments-in-kind, for instance to cover worker training schemes (UNCTAD 2014).

Job creation is typically the most important objective of governments designing investment incentives directed at inward foreign investment activity, followed by technological upgrading, the promotion of exports and the creation of backward and forward linkages, all of which are increasingly associated with efficiency-seeking FDI (UNCTAD 2014).

Given that investment incentives can take various forms, spanning fiscal, financial, regulatory, technical, or business support (Johnson, Lise and Perrine Toledano, 2013), they can also be classified according to whether they are:

- (a) direct or indirect;
- (b) financial or implicit;
- (c) general or sector/industry/firm-specific;
- (d) unconditional or contingent; and
- (e) incremental or non-incremental (OECD, 1996).

An alternative classification of investment incentives distinguishes between rules-based approaches and specific approaches. In so doing, it builds on the type of method used by governments to implement investment incentives, i.e., discrimination of investors stipulated by law, in the former case, and incentives tailored to individual foreign investors or investment contexts, in the latter case (OECD, 2003).

In addition to the above categorisations, investment incentives can be distinguished as comprising targeted competition incentives, which reflect the desire of host country (region) authorities to outbid the incentives provided by other

jurisdictions to attract individual FDI projects, as well as regime competition incentives, which refer to the overall system of incentives put in place by a host country government to compete with the practices of other jurisdictions (OECD, 2003).

From the vantage point of their objectives, investment incentives can be further distinguished into two distinct categories:

- (a) locational incentives aimed at influencing investors' decisions on where to locate; and
- (b) behavioural incentives aimed at inducing investors to engage in certain desired conduct in the light of specific policy goals — creating linkages with local suppliers, fostering research and development (R&D) and innovation, job creation, or enhancing indigenous human capital (Echandi, 2015).

Investment incentive programmes are often designed in a horizontal (cross-sectoral) manner to raise the overall attractiveness of the economy. But, governments may also implement targeted incentives that are more limited in scope. These include sector-specific incentives that are predominantly directed toward firms operating in services industries, with information technology (IT), business services, and tourism ranking among the most frequent beneficiaries (UNCTAD, 2014).

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## INVESTMENT INCENTIVES: GLOBAL AND REGIONAL TRENDS

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With continued strong growth of FDI directed toward service industries, the policy actions adopted by governments with a view to liberalising markets, promoting investments, privatising sectors, and implementing facilitation (investment climate enhancing) measures take centre stage.

Of all the policy tools available to governments concerned by investment climate dynamics, and in response to heightened locational competition within and across borders, the past decade has witnessed a marked rise in the use of investment incentives. To some extent, this proliferation can be traced to the absence of international rules disciplining their use, particularly in service industries. UNCTAD reports that during



the period from 2003 to 2014, the share of investment incentive programmes in the total number of liberalisation, promotion, and facilitation measures more than doubled, rising from 26 to 55 percent of observed yearly changes in host country investment measures (UNCTAD, 2014).

Although investment-related incentive policies have tended to proliferate in all corners of the world, over the past decade, such policies have been used most intensively by countries in Asia and Africa. According to the Asian Development Bank, the investment incentives used by Asian host economies are chiefly targeted in character and often relate to the establishment of special economic zones — in part to bypass the prohibition of tax incentives for exporters established by the World Trade Organization (WTO) subsidy rules. Asian incentive programmes often pursue a specific approach, with incentives resulting from discretionary deals between host country governments and multinational investors (Johnson and Toledano, 2013).

A 2011 African Investor Report carried out by the United Nations Industrial Development Organization (UNIDO) on the use of investment incentives in 19 sub-Saharan countries revealed the pervasiveness of tax-based incentives in extractive industries, followed by non-fiscal and non-financial incentives (UNIDO, 2011).

With respect to outward FDI, government support in the form of institutionalised home country policies is a more recent phenomenon, concentrated chiefly in emerging markets where firms have come of age as global players over the past decade. It is thus not altogether surprising that the current institutional structure concerning incentives for outward FDI remains quite fragmented and embryonic in these countries — though one could largely say the same of developed country settings (Sauvant et al., 2014). Interestingly, outward FDI promotion services often accompany trade and inward FDI promotion services.

Although there is growing concern about the increasing control of outward FDI stock by SOEs, home country support of various forms are often granted to both SOEs and private companies regardless of the ownership structure of supported entities, as exemplified by the 2012 joint decision of the Chinese National Development and Reform Commission and the Ministry of Finance to treat SOEs and private firms equally with respect to the disbursement of public funds (Sauvant et al., 2014). The same appears to hold true of the granting of outward investment incentives of a fiscal nature by developed and emerging economies, which neither generally appear conditioned on ownership characteristics nor linked to considerations, such as company size, sector of economic activity, or FDI destination (Sauvant et al., 2014).

Moreover, issues of competitive neutrality (a playing field where no business is advantaged or disadvantaged based solely on ownership or nationality considerations) may arise also in a context where ownership considerations are not as relevant as they once were. Indeed, competitive neutrality

may be distorted when home country private firms enjoy government support to establish affiliates abroad, thus placing them in a more advantageous position than fellow competitors from other countries that have not been granted any incentive from their own governments as well as other private firms in the home country that do not enjoy similar government support (Sauvant et al., 2014). Still, the existence of *de jure* non-discriminatory rules on outward investment incentives does not necessarily exclude *de facto* discrimination, as SOEs may receive other indirect advantages that are not afforded to non-SOEs entities, thus tilting competitive conditions in the recipient country in their favour.

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## INVESTMENT INCENTIVES: A DEVELOPMENT PERSPECTIVE

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Given the increasing use of investment incentives by countries across all geographical regions and income levels, asking whether such policy instruments are effective seems a rather legitimate question. Are such measures inefficient when they encourage production to move to a suboptimal location for the manufacturing of goods or the supply of services? Does their use allow for the effective correction of market failures? Can investment incentives be shown to produce positive externalities, such as the transfer of knowledge or the creation of durable linkages with local suppliers? Do incentives result in a misallocation of public funds and prompt beggar-thy-neighbour responses?

A cursory review of the available literature suggests that the answer to all of the above questions would appear to be unequivocally — and paradoxically — affirmative, making discussions of the efficacy of investment incentives a decidedly contentious public policy issue.

A large volume of scholarly work has indeed been directed to studying investment incentives and their effects on economic growth, technology deepening, and locational decisions from a variety of angles. For instance, recent studies carried out by James (2013), Tuomi (2012), and Miroslava (2013) focused on the analysis of a single country or a specific subset of economies. Others, such as Klemm and Van Parys (2011), zeroed in on a single type of instrument (tax incentives) while others (Jenner, Groba, and Indvik, 2013), explored the effectiveness of investment incentives in a distinct sector (renewable energy). While several studies have dealt mainly with the political economy aspects of investment incentives, others have chiefly looked at firm behaviour.

Although the criteria used to assess the possible impacts of FDI incentives may vary, the financial sustainability of the schemes as well as the potential misallocation of governments' financial resources rank among the most frequently cited. Indeed, the desirability of investment incentives as a potentially effective instrument to foster cross-border investment activity and the spillovers generally associated with them are often measured against the burdens they may place on a government's financial resources, a challenge widely seen as most acute for developing countries. Still, in order to determine the overall effectiveness of investment incentives, their fiscal sustainability should be assessed against the benefits, spillovers, and other potential positive aspects they generate (Echandi, 2015). However, identifying the value, ultimate beneficiary, and type of investment incentives is not an easy task, as most of the necessary data is not readily available (OECD, 1996).

Still, in shedding analytical light on the economic impact of investment incentives, the OECD has identified five main criteria to be used to measure the potentially wasteful effects of FDI incentives:

- (i) ineffectiveness, which results from the inability of investment incentives to produce enough benefits to outweigh costs;
- (ii) inefficiency, which is caused by the authorities being unable to maximise the benefits, even when they outweigh budgetary costs;
- (iii) opportunity costs, which occur whenever a government's financial resources are scarce and could be better allocated;
- (iv) deadweight losses, which refer to instances where investment incentives were not needed, failed to address the intended recipients, or the like; and
- (v) triggering competition, which occurs whenever an investment incentives regime adopted by a government may trigger an escalating confrontation with other jurisdictions based on the most generous incentive package, with negative consequences on the long-term (but also short-term) financial sustainability of such schemes (OECD, 2003).

Despite an abundance of studies on the topic, the existing economic literature offers contrasting evidence on the effectiveness of investment incentives in influencing the decision-making process of the economic actors at which such incentives are directed, or in benefiting the host economies to which the investments are destined.

What is beyond debate, however, is the fact that the past several decades have witnessed a significant escalation in the packages of tax breaks, incentives, free land, below market-priced office space, subsidised training, and other subsidy programmes offered by both developed and developing countries to attract investors and/or to keep home country

investors in place (Thomas, 2000; Moran, Graham, and Blomstrom, 2005). Increasingly popular is the view, anchored in a rising body of econometric evidence, documenting how multinational investors are becoming steadily more responsive to locational incentives, with competition growing between developed and developing country sites, and with sensitivity to production being particularly pronounced in export-related activities, i.e., over efficiency-seeking FDI embodying the GVC phenomenon<sup>2</sup> (Mutti, 2003; Altshuler, Grubert and Newlong, 2001; Moran, Graham and Blomstrom, 2005). The above trends find a parallel in the marked growth observed of late in the number of national investment promotion agencies, in their rising budgets, and the increasingly sophisticated range of incentives they offer.

Still, the debate rages in academic and policy circles over the effectiveness, sustainability, and fairness of locational competition in a world characterised by increasingly footloose cross-border investment activity. At one (negative) extreme of the analytical spectrum lies James (2013), who asserts that investment incentives produce little by way of FDI additionality, arguing that governments should primarily concentrate on their policy fundamentals and improve their investment climate, which is crucial for FDI-attracting purposes. Such a view is echoed in a literature survey on incentives and the locational decisions of multinational enterprises (MNEs) carried out by Johnson and Toledano (2013), which argues that, on balance, and across all categories of FDI (and not only efficiency-seeking FDI), investment incentives do not display a predominant role in the locational decisions of foreign investors. Such a conclusion was corroborated by UNIDO's African Investors Report of 2011, which highlighted how investment incentives ranked at only 11 out of 12 factors that were put for consideration for investors' locational decisions, while economic and political stability were considered to carry more weight in their decision-making process (UNIDO, 2011). The latter results are perhaps not fully surprising given the nature of FDI that the African continent attracts — natural resource-seeking FDI — for which locational incentives are arguably naturally wasteful (though the case for behavioural incentives may be significantly stronger to promote backward and forward linkages in enclave economies), as well as in the light of the deep-seated governance challenges encountered in many of the continent's host economies. Echandi (2015) further supports the view that, because investor decisions on where to locate are mainly influenced by broad economic and investment climate factors as well as human capital availability, investment incentives assume relevance only when investors are wavering between like options and the investment climate in the host state is already favourable. This

2 Work by Mutti (2003), cited in Moran, Graham and Blomstrom (2005), shows that the propensity of multinational firms to base their locational decisions on host country tax policy is strongest for plants producing manufactures for export in developing countries. Mutti estimates that tax measures that reduce the cost of capital by 1 percent raise multinational production in the manufacturing sector in host economies by 3 percent.



is particularly true for natural-resource-seeking<sup>3</sup> and market-seeking investors,<sup>4</sup> who tend to be less influenced by the incentives offered by the host state (Echandi, 2015).

At the same time, evidence from Chinese investors concerning their outward FDI activities suggests that home country policies adopted by the Chinese government have been considered helpful by the majority of investors, both private entities and SOEs, making use of them (Sauvant et al., 2014). Echoing the point made above on the influence of investment incentives for efficiency-seeking FDI, Miroslava's (2013) assessment of incentives granted by the Czech government to 30 foreign companies over the 1998-2011 period suggests that such support measures have proven mostly effective using a variety of performance metrics, although she considers that they might not be necessary were the government to lower corporate taxes and maintain greater political stability in the country.

## THE POLITICAL ECONOMY OF INVESTMENT INCENTIVE RULE-MAKING

An examination of the political economy of rule-making in the area of investment, and particularly of potentially trade-, investment- and competition-distorting measures, such as investment incentives, is crucial to better grasp the scope and nature of existing disciplines on investment incentives, the impact recent developments in global trade and investment (the rise of GVCs) exert on the nature and intensity of cross-border locational competition, and on prospects for developing new disciplines in the area.

The idea of establishing an international investment regime, which initially arose in the late 1940s during negotiations of the Havana Charter on the creation of the International Trade Organization (ITO), was not taken up seriously again until an attempt was made in the late 1990s to conclude an OECD-anchored Multilateral Agreement on Investment (MAI). The MAI's desultory outcome shifted the focus of international discussions on investment-related matters to the WTO and the so-called Singapore Issues,<sup>5</sup> whose equally desultory fate was sealed at the 2004 WTO Ministerial Meeting in Cancun, when negotiators agreed to drop three of the four Singapore issues, among which investment, from the ongoing Doha Round's agenda. This has meant, in practice, that bilateral investment treaties and preferential trade agreements

featuring comprehensive investment disciplines have become the preferred (indeed only) routes for advances on rule-making and liberalisation on the investment front.

The stillborn nature of multilateral discussions on investment does not, however, connote a complete absence of international disciplines. Such rules do exist, though they are scattered across a variety of WTO instruments rather than found in one coherent whole.<sup>6</sup> The tale of the missing multilateral regime for investment remains a paradox in a world economy where FDI, more than (but complementary to) trade, is the leading vector of cross-border integration.

More specifically, the WTO's Agreement on Subsidies and Countervailing Measures (SCM) and the Agreement on Trade-Related Investment Measures (TRIMs), both of which prohibit subsidies and local content requirements made contingent on the grant of an incentive; the General Agreement on Trade in Services (GATS); as well as the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) all include provisions which, directly or indirectly, feature elements of an international regime on investment. For example, Mode 3 (commercial presence) of the GATS anchors a process of progressive liberalisation of investment measures in a sector that accounts for some two-thirds of aggregate FDI flows and an estimated four of five investment barriers (Sauvé, Molinuevo, and Tuerk, 2006).

In addition to the multilateral disciplines described above, the past two decades have witnessed a spectacular rise in the number of bilateral investment treaties (BITs) and preferential trade agreements (PTAs) featuring extensive disciplines on investment protection and liberalisation. While the majority of BITs are more concerned with matters of post-establishment investment protection, PTAs feature comprehensive investment norms focused on both protection and liberalisation issues, and are typically aimed at creating a more favourable investment climate that would be conducive to increased flows of investment among parties and non-parties (when liberal rules of origin toward third-country investors are adopted). PTAs tend to make greater use of instruments like exceptions, transition periods, and reservations to ensure flexibility in liberalisation obligations.

3 Natural resource-seeking investments, which occur when investors' wishes to access resources that are located in a specific geographical location are strongly influenced by the conditions for gaining access to these resources and the investment climate in general. They usually generate large quantities of communities for export. See Echandi (2015).

4 Market-seeking investors are motivated by the desire to deliver goods and services in the host state, thus making them more sensitive to the size and characteristics of the domestic market as well as the investment policy of the host country. See Echandi (2015).

5 The Singapore Issues describes four new topics — investment, competition, transparency in public procurement, and trade facilitation — that were placed on the WTO's agenda at the 1996 Ministerial meeting held in Singapore.

6 For a fuller discussion of the treatment of investment-related issues in the WTO, see Sauvé (1994).

More frequent recourse to preferential routes to investment rule-making can be attributed to a number of factors, among which the stalling of multilateral negotiations under the Doha Development Agenda (and the rejection of investment on the menu of the Singapore Issues) as well as political economy considerations arising from recent developments in the world economy, notably the relative decline of Western hegemons —the United States (US) and the European Union (EU) — and the concomitant rise, including as significant FDI source countries, of a growing number of emerging powers seeking their place in an evolving global governance architecture.

A quick perusal of agreements covered by the WTO's regional trade agreement (RTA) database shows that more than 100 such agreements address investment-related issues either through the inclusion of a specific chapter on investment or by reference to investment-related matters in specific provisions. Moreover, all of the most recent mega-regional trade agreements under negotiation (or recently concluded) around the world feature extensive investment-related provisions in dedicated chapters. This includes the Canada-EU Comprehensive Trade Agreement, Trans-Pacific Partnership between the US and a number of Pacific Rim countries, the Transatlantic Trade and Investment Partnership between the US and the EU, the Regional Comprehensive Economic Partnership Agreement linking ASEAN countries to six regional partners, among which China and India, the Pacific Alliance linking four like-minded Latin American economies,<sup>7</sup> as well as the Tripartite Agreement linking three of Africa's largest regional integration schemes.

An important observation concerning the above mosaic of investment rule-making is that, with very few exceptions (the principal being the EU's state aid doctrine in the context of its single market<sup>8</sup>), virtually all existing (and proposed) treaty instruments eschew legally binding disciplines on the potentially distortive effects of investment incentives. Indeed, although International Investment Agreements (IIAs) and multilateral agreements do address, to some extent, investment-distorting measures —for example, the TRIMS Agreement prohibits a number of performance requirements found in breach of GATT Articles II.4 (National Treatment) and XI (Prohibition of Quantitative Restrictions) — none of them feature disciplines targeted specifically at the use of investment incentives (OECD, 1996). Whether under the GATS negotiations (in Article XV), the failed MAI, the subsequent WTO Working Group on the Relationship between trade and Investment, or the thousands of BITs and hundreds of PTAs, host countries — both developed and developing — have repeatedly and steadfastly expressed a collective preference for regulatory inaction and the preservation of policy immunity with respect to investment-related subsidy practices. Accordingly, neither the WTO nor IIAs currently feature a credible set of disciplines on the distortive effects of investment incentives.

Such regulatory inaction is somewhat paradoxical, as the uninterrupted escalation of what Moran, Graham, and Blomstrom (2005) call "revenue giveaways" arguably makes

the need for collective action more pressing. Developed and developing countries alike, and particularly the latter, share a common interest in generating greater public awareness (transparency) on incentive practices and to control and possibly cap tax breaks and locational incentives on an international basis. Yet precisely the reverse of international cooperation has occurred. Several reasons can be adduced in explaining such an outcome, most of which are of a political economy nature. Two in particular warrant closer attention: (i) the renewed buoyancy of the "market" for the preservation of policy space, itself a reflection of a rehabilitation of sorts for support for more activist forms of industrial policy; and (ii) the proclivity in investment policy to discriminate in favour of *foreign* economic agents.

With reference to the former, the absence of a political appetite for disciplining investment incentives reflects without doubt the willingness of host country governments to preserve their policy space for purposes of FDI attraction and retention. This is true despite conflicting evidence on the economic efficacy of incentive programmes in fostering FDI and the persistent voicing of concerns directed toward the possible misallocation of public funds such incentives represent.

The repeated conduct of host country governments suggests beyond reasonable doubt their greater concern with being able to "play the game" in a world where locational competition over participation in global and regional value chains has become increasingly fierce, leaving smaller and/or geographically more remote countries (or regions within countries) vulnerable to information asymmetries and other market failures that justify recourse to more activist forms of industry support.

Regulatory inaction also proceeds from the peculiar political economy of investment attraction, which often necessitates host country governments to extend to foreign investors privileges not available to domestic investors. Such "better than national treatment" outcomes create an alliance between host countries and foreign investors that militate against stringent disciplines toward likely distorting practices.<sup>9</sup>

The lack of substantive disciplines governing the use of patently distortive industry support measures encourages host country governments to rely on these types of policy instruments to the detriment of alternative measures. Investment incentives might well be suboptimal instruments or second-best options resorted to by governments because their use is weakly constrained by international law rather than

7 The member countries of the Pacific Alliance are Chile, Colombia, Mexico and Peru.

8 See Sauvé and Soprona (2015) for a fuller discussion of the EU's state aid doctrine.

9 One should not, however, underestimate the political pressure that some domestic constituencies can exert on home country governments, especially those that may feel threatened by FDI-induced market entry by foreign investors.

because they represent the best policy tools to apply to attract and retain FDI.

The recent escalation of investment incentives does raise legitimate “beggar-thy-neighbour” or “race-to-the-bottom” concerns when looked at from a world welfare perspective. Indeed, if a government offers generous tax incentives to foreign investors to (re-)locate their production or commercial presence in its territory, that host country’s quest to attract foreign investments, with a view to creating jobs, transferring knowledge, and increasing the overall welfare of its citizens, may prompt other governments to outbid it by offering even more generous incentive packages, thus triggering a “race-to-the-bottom” with FDI over-subsidisation as the main outcome. The problem, of course, is that world welfare considerations rarely, if ever, command enough buy-in to translate into effective international cooperation, all the more so in the mercantilistic ecosystems of trade and investment negotiations.

But, over-subsidisation may not be the only key problem arising from the adoption of a “race-to-the-bottom” strategy. Bidding wars between countries to influence the flow of investments may lead to excessive expenditures of public funds, which can be particularly critical for those developing and transition economies with limited financial resources.

## POLICY RECOMMENDATIONS

Considering the escalating use of investment incentives, the lack of progress on — and, indeed, of political interest in — negotiations aimed at the development of disciplines regulating the potentially investment-distorting effects of investment incentives, and the unique political economy that shapes policy debates on the design of incentive schemes, prospects for significant forward movement in this area hardly seem bright. For much of the past two decades, countries of all sizes, income levels, and political persuasions have reaffirmed a clear preference for preserving their policy space and shown little interest in negotiating rules that may erode it, even when the main object of agreed disciplines is to promote the use of economically optimal and politically fairer industry support measures.

Are calls for negotiations on rules aimed at curtailing the distortive impacts of investment incentives a waste of time? Although some measure of (realistic) pessimism may well be justified, it may still be possible to rekindle interest in a global

conversation on the issue in the light of a number of recent developments.

For any policy initiative to garner necessary political traction, credible information — through carefully targeted data collection — is a necessary precondition. Thus, it is essential for leading, independent, organisations, such as the WTO, the World Bank, the United Nations Conference on Trade and Development (UNCTAD), or the OECD to be entrusted, preferably in a cooperative manner given their respective comparative advantages, to gather detailed information on the nature, sectoral incidence, and geographical scope of incentives and their use. Such mapping could start, for example, from an overview of the use of investment incentives in various countries and with a quantitative assessment of their distortive effects on cross-border investment activity and distinguishing between different types of investments (market- versus efficiency-seeking) and sectors of economic activity (manufacturing versus services).

Disciplining potentially investment-distorting incentives requires an in depth understanding of the effects these policy instruments exert on the countries that grant them, on the investors that receive them, in terms of their ability to influence investment flows, as well as on third countries. Credible (enforceable) disciplines or even non-binding guidelines on best practices cannot gain durable traction in the absence of evidenced-based discussions. If more comprehensive data were to allow a fuller understanding of the factors and conditions that lead investment incentives to be more or less effective, countries might be more open to considering the possibility of distinguishing between “good” and “bad” incentives and devising disciplines that would generally limit recourse to the former and discourage the use of the latter. It is in this context, for example, that one could view the discussion on differences between locational and behavioural incentives. Although the former can offset market failures, their economic efficiency is highly debated, as they can readily divert investment away from locations that otherwise would have been chosen (UNCTAD, 2004). It may, thus, be desirable to discipline the use of locational incentives to neutralise any potential distortive effects or discourage their recurring application, even though countries have so far shown little interest in doing so. Behavioural incentives tend to be more efficient to the extent that they do not necessarily generate outright distortive effects and can actually be instrumental in fostering technology transfers, generating local supplier spillovers, and enhancing skills development. Such positive effects of behavioural incentives call into question the desirability of new disciplines that may frustrate their use and, consequently, reduce the potential benefits arising from their application. The collection of credible data would allow policymakers to better understand the differences, *inter alia*, between locational and behavioural incentives and evaluate the desirability and feasibility of disciplines targeted at the distortive effects arising from their application.

Another, complementary, step concerns the need to generate greater transparency on investment subsidy practices through

the creation of proper notification channels, documenting both the nature of incentives used and the level of expenditure (or foregone fiscal revenue) attached to such measures. By promoting increased international transparency through the establishment of objective criteria and regular notification procedures, countries would reduce the incentive to free ride while promoting greater accountability to domestic taxpayers. Gathering the hard and soft data depicted above would allow policymakers to better assess the costs and benefits of various incentive schemes and, through international comparison, help identify possible negotiating bargains in areas of common concern or practice. In addition, promoting transparency would help reduce opportunities for corruption or undue administrative discretion in the granting of incentives while ensuring greater predictability for eligible beneficiaries.

Arguably, this may seem to be a somewhat tepid approach, but encouraging the collection of more reliable and comprehensive data and promoting increased regulatory transparency constitute feasible starting points that need not prove unduly controversial among host country governments. There is little denying that the development of new disciplines targeting the potentially trade-, investment- and competition-distortive effects of investment incentives is warranted. This is so, not least because existing disciplines are simply not up to the task and in light of new sources of distortion that the rise of capital-exporting SOEs enjoying significant home country support can bring in their wake.

Still, this paper's advocacy of a more cautious data-gathering approach proceeds from recognition of the limited political will that currently prevails to move this file forward.

Interestingly, recent developments in the EU suggest that scope for forward movement in this area may be achieved through the application of competition policy disciplines, rather than through trade or investment law (see Box 1).

The question of whether and when data collection generates an interest in rule-making is not one that can be answered credibly at this stage. Were such an optimistic scenario to unfold, countries could be encouraged to ponder the development of more stringent multilateral disciplines on investment incentives. As the OECD pointed out, healthy competition through cooperation between jurisdictions and the implementation of enforceable rules can allow incentives to improve the flow of investment projects — hence, producing local efficiency — while ensuring that the latter are matched to the locations where their value is greatest — thus, minimising distortions (Christiansen et al., 2003). Any agreed global compact on investment incentives should be binding enough to minimise the risk of deviation on the part of governments, but also flexible enough to allow host countries confronted with market failures of vastly differing intensity to pursue and enact legitimate industry support measures.

New disciplines on investment incentives could be built on a traffic light-like approach inspired by the SCM Agreement. Such disciplines could usefully distinguish various types of incentives based on their nature or use and adopt a variable geometry approach to their disciplining reach, depending on the economic characteristics of users.

A traffic light approach may also be considered in ensuring that SOEs behave in a competitively neutral way in foreign

#### **BOX 1:**

##### **EU state aid rules and tax incentives**

An October 2015 court ruling by the European Commission found that selective tax advantages provided to Fiat Trade and Finance in Luxembourg and Starbucks in the Netherlands were illegal under EU State Aid rules. Although the tax rulings that a country's national tax authority issues to artificially lower the taxes paid by a company are legal under EU rules, the European Commission found that the those under investigation were based on artificial and complex methodologies with no foundation in economic reality and created an unfair competitive advantage over other companies, especially small- and medium-sized enterprises, which are taxed on their actual profits under the same national systems (European Commission, 2015a). Whilst stating that further inquiries into tax ruling practices will be extended to all EU Member States, the European Commissioner responsible for competition acknowledged that fair tax competition in Europe cannot be achieved only through the enforcement of state aid rules and called for a combination of legislative action and competition enforcement, as well as greater transparency (European Commission, 2015b).

The implications of the EC ruling on investment in Europe can be far-reaching. EU Member States might be forced to review their investment incentive strategies, as tax rulings that are currently widely used risk being found illegal under future investigations, thus undermining the principle of predictability that helped lure multinationals into a country through selective tax advantages (Reuters, 2015). Moreover, a modification of the investment climate in the EU may reinforce calls for corporate tax harmonization, and put enough pressure on politicians to engage in negotiations on disciplines on investment incentives beyond the realm of EU rules on state aid.

markets. The question does arise, however, whether putative SOE disciplines should include specific provisions on investment incentives related to outward FDI, or whether investment incentives should rather be disciplined by a different set of generic provisions covering both inward and outward FDI and thus target all potential investors irrespective of their ownership structure. The former approach might generate an unwarranted and politically contentious differentiation between SOEs and private firms, even when in practice both can affect competitive neutrality in the recipient market. Considering that fiscal and financial support to outward FDI tends to be offered on a non-discriminatory basis, the second approach might well prove advantageous by encompassing all possible types of competitive distortions arising from incentives.

The ascendant use of investment incentives offers a clear example of a policy challenge of potentially global incidence that should ideally command a global governance response founded on the increasing complementarities of trade, investment, and competition law and policy as the core pillars of a more open, inclusive, and just world economy.



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